

AN OVERVIEW ABOUT TRANSFER PRICING PRACTICES

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ARTICLE INFO

Article History:

Received: 23 Jan 2017;

Received in revised form:
30 Jan 2017;

Accepted: 31 Jan 2017;

Published online: 31 Jan 2017.

Key words:

Pricing Practices,
Multinational Corporations,
Transfer Pricing,
Pricing Policies
Profit

ABSTRACT

Multinational Corporations (MNCs) use transfer pricing practices to reduce taxable profit with a view to recommend how such practices could be minimized, to enhance the tax revenues of their host countries. The various MNCs take advantage of different tax rates charged in different jurisdictions to minimize the groups' tax liabilities. Using transfer pricing practices to shift profit from high-tax jurisdictions to low-tax jurisdictions. Multinational corporations as integrated entities exploit international differentials and generate integration economies by setting transfer prices that are unlikely to be the same prices arms length parties would negotiate. Tax authorities should be aware of the need to publish documentations requirements concerning transfer pricing, so as to improve on monitoring of MNCs transfer pricing compliance. Transfer pricing must be provided to tax authorities for computation of both border, and corporate income taxes. This is necessary since the activities of MNCs cut across national borders.

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INTRODUCTION

Transfer Pricing (TP) has assumed lot of importance today. It is one of the important tools in the hands of management for performance evaluation of a division or department. TP has become necessary in highly decentralized companies where number of divisions/ departments is created as a part and parcel of the decentralized organization. In the modern days, production is on the mass scale due to technological advancement and up gradation. Organizations grow in course of time and for such growing organization, decentralization becomes absolutely necessary. It becomes inevitable for such growing organizations, decentralization becomes absolutely necessary. It becomes inevitable for such organizations to establish separate divisions and departments to ensure smooth working. However it is also necessary to evaluate the performance of these departments/divisions.

How to cite this article: Sridevi, J., & Ranjithkumar, S., (2017). "An Overview about Transfer Pricing Practices". *International Journal of Advanced Scientific Research & Development (IJASRD)*, 04 (01/I), pp. 45 – 50.

Transfer Pricing is one of the tools in the hands of management for measuring the performance.

A Transfer Price (TP) is that notional value at which goods and services are transferred between divisions in a decentralized large business organization. Some companies have the problem of pricing of goods and services which are transferred to other divisions/units of the same company; such pricing is referred to as 'intracompany', 'intradivisional', or 'transfer pricing'. As explained in the above paragraph, in large organizations, each division is treated as a 'profit centre' as a part and parcel of decentralization and transfer of goods and services amongst the independent profit centre take place, the problem of intracompany transfer pricing arises. Geographically dispersed or international companies often face the problem of pricing goods and services, which are transferred to other divisions or units of the same company.

An intermediate product is a product transferred from one sub-unit to another sub-unit of the same organization. This product may be processed further or sold to an external customer. A TP is the price one sub-unit (segment, department, division, and so on) of an organization charges for a product or services supplied to another sub unit of the same organization. The TP creates revenue for the selling division and purchase costs to the buying division, affecting operating income for both divisions. The operating incomes can be used to evaluate the performance of each division and to motivate managers. Some companies have the problem of pricing TP are normally set for intermediate products, which are goods, and services that are supplied by the selling division to the buying division. Their profitability is measured by fixation of TP for inter divisional transfers.

QUALITIES OF GOOD TRANSFER PRICING POLICY

The following are the qualities of a good transfer pricing policy as postulated by ICAN (2009) and Adeniyi (2008);

- **Goal Congruency:** There is a need to select the transfer pricing method that will ensure that any optimal decision taken by the division will also be optimal from the corporate perspective. In other words, any method chosen must reduce sub-optimality to the barest minimum. This is also known as the concept of uniformity of objective. The condition implies that a good transfer pricing policy must be used to sacrifice the long term corporate objectives of the entire organization for personal or divisional objective.
- **Performance Evaluation:** An ideal transfer pricing must be capable of being relied upon as a premise for evaluating divisional performance in terms of efficiency level and effectiveness. There is a need to select the transfer pricing method that management would be in a position to adopt in evaluating the performance of each divisional manager as effectively as possible. Sequel to this, the contribution made towards the corporate profit by each division should be distorted by the transfer pricing method chosen.
- **Autonomy:** There is a need to select the method that will preserve the independence of each division so that the failure of one division will not affect the success of another division. The transfer price must be set such that it guarantees the independent nature of all the divisions involved.

- **Motivation:** The agreed transfer price must be capable of motivating both the buyer and the seller or the transferor and the transferee. This objective or quality of transfer pricing has to do with an in-house issue. The price that is fixed is to be accepted by the parties involved; this is as a result of what the organization seeks to achieve by fixing such transfer price.

METHODS OF TRANSFER PRICING

It will be relevant to conceive at the onset that it may not be possible for a particular method of transfer price to simultaneously achieve all the listed qualities or objectives above. As a result of this fact, the quality of performance evaluation will contradict goal congruence and it is also doubtful if a particular method of transfer can simultaneously motivate both the buyer and the seller. The following are the different types of transfer pricing method in use by organization:

- **Cost Based Transfer Method:** Under this approach, the relevant transfer price to charge between the transferring division and the receiving division will depend on the actual cost of production to the manufacturing division (Adeniyi, 2008). The selling division sells the goods to the buying division at the cost of production incurred by the selling division. It should be noted that cost is viewed in different ways and as such ICAN (2009) and Adeniyi (2008) posit that cost based transfer pricing method is further categorized into relevant cost, total cost, mark-up and standard cost transfer prices. Cost based transfer pricing have advantages of it being useful in decision making analysis, especially where the organization is using the marginal costing approach; also, it assists in measuring production efficiency by comparing actual cost with budget. Cost based transfer pricing has no unrealized profit involved in its stock computation and it offers the only available opportunity for products that have no market. The major disadvantage of this method is that, managers who are supposed to be autonomous are not allowed to use their initiative in the pricing decision, which may result to encouraging sub-optimality among the divisional managers. The approach cannot be used to evaluate divisional performance especially those identified as a profit or an investment centre.
- **Negotiated Transfer Pricing:** Under this method the selling division and the buying division agree in advance to use a mutually acceptable transfer price. The relevant transfer price to charge between the selling and buying divisional managers will represent the outcome of negotiation between the two divisional managers. The central management will encourage the two divisional managers to agree on the appropriate transfer price because many factors have been have been effectively considered to reduce disputes on the transfer price fixed. With the use of this method, the motivational impact among managers will be stronger and the method is not prone to market fluctuations. The method is not encouraging as negotiation may be time consuming. The price to be fixed may be influenced by the negotiating ability, personality and fluency of the managers involved which may result to the corporate interest being subordinated to individual divisional interest and goal dissimilarity. It is not a good method of evaluating performance as it can be used to conceal inefficiency on the part of the managers involved.

- **Arbitrary Transfer Pricing:** Under this method the transfer price is determined centrally based on what top management conceived to be the most beneficial to the company as a whole. Individual divisional managers may have some say but no control over the price set. In other words, the relevant transfer price to charge between the selling and buying divisional managers will be determined by the central management with or without the consent of divisional managers. The time spent in negotiation is saved, and uniformity and stability tend to prevail. The approach is considered ideal for planning purpose because of its specific nature and will guarantee the concept of goal congruency. It does not grant the divisional managers autonomy and the profit and cost consciousness may suffer if the fixed price is not considered realistic.
- **Market Based Transfer Price:** Under this approach, the relevant transfer price to charge between the selling and buying divisional managers will represent the prevailing market price within the market as at the date of the transaction. This implies that both the selling and buying divisional managers are expected to operate at arm's length. A major plus for using this approach is that it guarantees divisional autonomy and allows for divisional managers to use their initiative in the pricing decision, which in the long run allows for performance evaluation among the managers. Its shortcoming is that, because of its market nature, it is prone to market fluctuations and will complicate the process of stock valuation as a result of the need to eliminate the unrealized profit on stock.

INTERNATIONAL TRANSFER PRICING

As the number of multinational enterprises increases, the number of transactions between entities belonging to the same multinational group rises as well. Intercompany transactions generally offer the opportunity to shift income from one jurisdiction to the other. Income shifting can be driven by tax aspects, for instance a tax rate differential, or by firm-specific tax attributes like tax losses. At the same time, profit shifting imposes risk to governments as it may reduce tax revenues.

The correct transfer price for decision-making may conflict with the price which is used to determine profits for the assessment. This conflict may arise when the supplying and receiving divisions are located in different countries with different taxation rates. International transfer pricing policies became increasingly complex as companies increase their involvement in international transactions through foreign subsidiaries, joint ventures, and parent-owned distribution systems. The increasing participation of multi-national groups in economic activities in the Country has given rise to new and complex issues emerging from transactions entered into between two or more enterprises belonging to the same multi-national group. The profits derived by such enterprises carrying on business in India can be controlled by the multi-national group, by manipulating the prices charged and paid in such intra-group transactions, thereby, leading to erosion of tax revenues.

ARM'S LENGTH PRICE

A price which is applied or proposed to be applied in a transaction between persons other than associated enterprises, in uncontrolled conditions. The arm's length price in

relation to an international transaction or specified domestic transaction shall be determined by any of the following methods;

- (a) Comparable uncontrolled Price method
- (b) Resale Price Method
- (c) Cost Plus Method
- (d) Profit Split Method
- (e) Transactional Net Margin Method
- (f) Such other method as may be prescribed by the Board.

ADVANCE PRICING AGREEMENTS

In the course of the application of transfer pricing regulations, disputes may arise between taxpayers and tax authorities. An adjustment of transfer prices by one jurisdiction can lead to double taxation as the other jurisdiction may not always agree with the adjustment. Thus, several approaches exist in order to prevent double taxation and minimize transfer pricing disputes which the OECD has outlined in its Transfer Pricing Guidelines.

Nevertheless, the overview shows that countries are increasingly offering advance pricing agreements. This may be an answer to the need of multinational companies to reduce their risk in transfer pricing matters as awareness is rising. But it can also be argued that the introduction of APAs functions as a tax incentive, giving the tax authorities a possibility to agree on rather flexible terms and thereby attracting investment.

CONCLUSION

As intercompany profit shifting offers opportunities for international tax planning, many countries focus on transfer pricing regulations in order to secure tax revenues. The majority of countries introduced transfer pricing regulations in the last two decades. Only 7 out of the 44 considered countries do not impose transfer pricing regulations which may be explained by them being either low-tax or developing jurisdictions. Where present, transfer pricing regulations usually apply to foreign related parties only. An exception holds for those countries offering tax incentives where also domestic related parties are subject to the rules. The methods outlined by the OECD are mainly accepted. Only differences exist, however, in the priority of methods. While the majority of countries prefer the traditional methods over transactional profits methods, nine countries apply a best method rule. Documentation requirements were introduced to a great extent in the considered time period. The design of penalties is similar - usually a certain percentage on the tax adjustment, a late interest, and a fixed monetary fine on noncompliance - but the amounts vary notably. In case of fraud, penalties are often at least doubled. The possibility to enter into advance pricing agreements is increasing with only nine countries not allowing for such agreements.

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